Consulting Assistance on Economic Reform II

REPORTS

The objectives of the Consulting Assistance on Economic Reform (CAER II) project are to contribute to broad-based and sustainable economic growth and to improve the policy reform content of USAID assistance activities that aim to strengthen markets in recipient countries. Services are provided by the Harvard Institute for International Development (HIID) and its subcontractors. It is funded by the U.S. Agency for International Development, Bureau for Global Programs, Field Support and Research, Center for Economic Growth and Agricultural Development, Office of Emerging Markets through Contracts PCE-C-00-95-00015-00 and PCE-Q-00-95-00016-00.

Institutional Barriers to NonTraditional Exports in Africa

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Report G
September 2000

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INSTITUTIONAL BARRIERS TO NONTRADITIONAL EXPORTS IN AFRICA

DISCUSSION PAPER

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February 1998

I. INTRODUCTION

A. Statement of the problem

A number of countries in sub-Saharan Africa have undertaken major policy reforms over the past one and one-half decades. These have often comprised some combination of (1) devaluation, (2) movement towards a more flexible exchange rate, (3) easing or elimination of foreign exchange controls, (4) reduction or elimination of export taxes, (5) easing or elimination of import controls, (6) reduction in the magnitude and variability of import tariffs, (7) privatization or reform of government parastatals, (8) elimination of price controls and restrictions on private marketing, and (9) reduction of public sector employment. The reforms have been designed to alter the structure of incentives in the direction of opening the economy to international trade and increasing the relative importance of the private sector. The ultimate goal has been to increase economic growth.

With the advent of reform, resources are being reallocated towards more productive activities. In the past, these activities have consisted essentially of two types: import-competing production for the domestic market and traditional primary product exports. Opportunities for further growth in these sectors, however, are limited. First, expansion of production for the domestic market is constrained in most countries by its small size. Second, although there is some scope for increasing traditional primary product exports, and perhaps recapturing markets lost to competitors elsewhere in the world, this avenue of growth is blocked by both demand and supply. On the demand side, world market prospects for many of Africa's traditional exports -- e.g., coffee, cocoa, tea, groundnuts, cotton, oil palm products, copper, bauxite, uranium -- are poor. On the supply side, population growth is pressing on the land suitable for livestock and cash crops, and mineral deposits and forest reserves are being exhausted.

In the future, African countries will have to rely increasingly on nontraditional exports as the engine of economic growth. A few countries have already begun to diversify their exports away from traditional commodities. Kenya, for example, has witnessed a major expansion of horticultural exports. Mauritius has moved from heavy reliance on sugar towards export of a range of manufactured goods. Madagascar has experienced growth of a number of nontraditional exports from both primary and secondary sectors, e.g., shrimp, butter beans, medicinal plants, meat, leather, cotton cloth, and garments. Ghana has witnessed rapid growth in exports of Afrocentric products such as cloth, garments, fashion accessories, household furnishings, and handicrafts.[2] Nigeria has been exporting manufactured goods to

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[1] The authors edited the report: “Cost and Benefits of Eliminating Institutional Constraints on the Expansion of Nontraditional Exports, Final Report” by J. Dirck Stryker and Christopher Shaw, Cambridge, MA, AIRD, October 1994.

[2] The potential for trade in Afrocentric products is explored in Tyler Biggs, Gail Moody, Jan-Hendrik van Leeuwen and E. Diane White, "Africa Can Compete! Export Opportunities and Challenges in Garments and Home Products in

the West African market, at least until the recent devaluation of the CFA and the reinstitution of exchange controls in Nigeria. Senegal is exporting labor-intensive products such as footwear to the European market.

Whether countries in sub-Saharan Africa can and should further expand these types of nontraditional exports depends on a number of factors. First is the pattern of comparative advantage that each country has in the production and export of these products. Second is the infrastructure that exists in transport, telecommunications, energy supply, and other areas essential to competitive export activity. Third, there is a need to invest in mechanisms for acquiring information on market opportunities, production technologies, and a number of other areas through the creation of professional and trade associations, the rehabilitation of agricultural research organizations, the upgrading of training and educational institutions, etc. Finally, there is a requirement to define more carefully the role of the public sector and the institutions that surround it.

Most African countries could profitably expand the range of exportable products that they produce. The Gambia, Guinea, Kenya, Madagascar, Mali, Senegal, and a number of other countries, for example, have a climate suitable for growing a wide variety of horticultural products. Other countries have substantial marine resources available for export. Many countries are profitably engaged in the production of primary products, such as cotton and livestock, which could be used as inputs into processing activities. Much of Africa could produce the Afrocentric products for which demand in the industrial world is rapidly expanding. Some countries have the pool of low-wage, semi-skilled labor that could enable them to follow the example of Mauritius in developing labor-intensive, standardized manufactured goods for export.

Africa's comparative advantage in labor-intensive activities is increasing vis-à-vis Asia's. There are several reasons for this. First, rates of population growth are higher, resulting in a rapidly growing labor force. Second, poor economic performance implies that real per capita incomes and wages have been relatively stagnant or even declining in Africa as compared with Asia, where economic growth has been much more pronounced. Finally, in many areas, Africa's population is beginning to press on an extremely fragile resource base. Unless pressure is taken off of these marginal lands through a diversification of employment opportunities, there will be a continuing downward spiral of poverty and resource degradation.

A number of countries that have undertaken major economic reform lack the basic infrastructure to support export-oriented activity. After years of neglect, countries like Ghana, Guinea, Madagascar, and Tanzania need to rebuild, expand, and modernize their roads, ports, airports, telecommunications equipment, and power generating facilities. This is especially important for the export trade because of the need for timeliness and flexibility in responding rapidly to overseas demand.

Investment in knowledge and other forms of human capital is also essential. The development of horticulture in Kenya depended on investments in research, training, and extension, yet too many countries have allowed their agricultural research and extension capabilities to deteriorate.[3] Countries, such as

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the U.S. Market," Regional Program on Enterprise Development Discussion Paper, World Bank, 1993.

[3] Nural Islam highlights the importance for exports of market information, quality control, processing and storage facilities, and agricultural research. He also describes how horticultural exports have served as a natural bridge to exports of nontraditional manufactured goods. See Nural Islam, *Horticultural Exports of Developing Countries:*

Mauritius, that have been successful with nontraditional exports have also had to acquire a knowledge of foreign market opportunities, develop linkages with foreign partners, pay close attention to quality control, and develop a pool of competitively priced semi-skilled labor.[4]

Finally, development of agricultural and industrial sectors that are capable of competing successfully on world markets requires the establishment and growth of institutions that define the role of the public sector in relation to private economic agents. These institutions include the government ministries, the central bank, and other public agencies involved with trade, investment, and finance. They also include the financial institutions, trading houses, professional associations, and other organizations that play a quasi-public role. Each of these interacts with the private sector through systems of business regulation, customs and tax administration, rules and procedures regarding the allocation of credit and foreign exchange, approvals for tax exemptions and other benefits, regulation of transportation and telecommunications, and a host of other areas.

B. Legal, Regulatory and Judicial Environment

Much of the definition of the relation between public and private sectors is contained within what has often been referred to as the Legal, Regulatory, and Judicial (LRJ) environment. Because market-oriented reforms as implemented in many sub-Saharan African countries have not always yielded the expected results, attention has been increasingly focused on the role of the LRJ environment in the lackluster performance of developing economies. Although this concept extends far beyond the export sector, it is nonetheless crucial to successful export growth.

The legal, regulatory, and judicial environment comprises not only laws and regulations but also machinery for the settlement of disputes, an apparatus for the enforcement of judgments, and a minimum degree of consensus among economic agents as to what constitute rules of the game. Of critical importance for a market economy is a legal system that reduces transaction costs and promotes risk-taking and investment activities. Such an environment is composed, *inter alia*, of:

(1) a well defined and market-friendly system of economic law and regulation, including such fundamentals as property rights, labor law, company law, and secured finance;
(2) a fair and predictable mechanisms of contract enforcement; and
(3) transparency, accountability and informational openness in governance which derives from a clear separation of legislative, executive, and judicial power.

For the purposes of this study, the most important part of the system is the body of business law and regulation that deals with such issues as incorporation, bankruptcy, secured transactions, regulation of competition, labor law, and environmental regulation. Regulation of business may extend to such areas as licensing and concessions, financial market regulation, price regulation, and intellectual property. Business

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Past Performances, Future Prospects, and Policy Issues, International Food Policy Research Institute, Research Report No. 80, April 1990.

[4] Foreign firms may play an important catalytic role, here, by providing access to the world market network, the capacity to package exports, and technical, marketing, and management knowhow. World Bank, Industry and Energy Department, and USAID, Bureau for Africa, *Building a Competitive Edge in Sub-Saharan Countries; the Catalytic Role of Foreign and Domestic Enterprise Collaboration in Export Activities*, December 10, 1991.

regulation pertaining primarily to the functioning of private markets may be distinguished from regulation relevant to public sector concerns, including taxation and monetary control.

Ideally, these laws and regulations serve to reduce transaction costs through streamlining of procedures and increasing predictability of outcomes. However, in many African countries, regulations tend to create additional barriers to business and trade and actually raise transaction costs, whether by intention--to increase equity--or unintentionally through poor design.

Also, African countries are still for the most part characterized by an imbalance of power. In many of these countries, the legal system is not sufficiently isolated from the locus of political authority and the executive branch operates with impunity, leading to abuse of power, conflict of interest, arbitrary decisions. This discourages investment by those who are not closely linked through family and other ties with those sharing political authority which ultimately hinders the emergence of a robust private sector.

Just as a legal infrastructure is required to support and enhance the functioning of a system of property rights, contracts, and torts, so is an infrastructure required to operate the system of business regulations, whether pertaining to the private or public sector. Such a system requires for its maintenance a cadre of specialized administrative and agency personnel and trained lawyers in order to ensure the legal functioning of government and the compliance of private parties with existing business regulation.

Finally, quite apart from the realm of private business actors, public agents, and the bodies of law that pertain to their interaction, lies a group of private institutions geared toward reducing further the transaction costs of commerce. This institutional group includes all of those services that exist to expedite the interaction of private commercial actors, and ranges from banks to stock exchanges, from insurance companies to trading houses. A distinct structure of laws, rules, and expectations governs this group of private institutional actors, who necessarily overlap with actors in both the private and public sectors.

Even though policy reforms in recent years have diminished the relative importance of ministries and other agencies of government, these institutions nevertheless play a vital role in implementing the laws and regulations which govern the private sector. Major issues relate to the capacity of these institutions for effective implementation and the potential that exists for abusive use of discretionary authority. Though laws and regulations designed to achieve social goals, such as those involving conditions of employment, might be quite laudable, the economic distortions that they introduce may easily make society worse off than if the laws and regulations had never existed.

A number of studies have examined problems related to the legal, regulatory, and judicial environment in Africa and elsewhere. Although these studies have quite effectively discussed these problems and how they are likely to inhibit private sector initiative, there has been no effort to quantify the harm done or to estimate the cost that it, or its avoidance, entails. As a result, there is little guidance as to the priorities for reform.

This study has developed and tested a methodology to identify and measure the importance of the institutional constraints that are inhibiting the growth of nontraditional exports in Ghana and Madagascar.[5] These two countries were selected because they have undertaken significant market-oriented reforms aimed at providing an enabling environment for the private sector to grow. The nontraditional sector was

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[5] Results for both case studies are presented in a separate discussion paper.

chosen for two reasons. First, as argued above, it is key to economic growth in most African countries over at least the next two or three decades. Second, the development of nontraditional exports, frequently in cooperation with foreign partners, requires that close attention be paid to the transactions costs associated with property rights, technology transfer, contracts, financing, investment incentives, trade policy, foreign exchange policy, and a host of other areas that can frequently be ignored if production is destined for the domestic market or for traditional export markets. Thus the nontraditional export sector can be seen as key to opening countries up to flows of capital, technology, and institutional innovation, which have proved elsewhere to be vital for economic development.[6]

C. Methodological Approach

The methodological approach used to assess the cost of institutional constraints is an extension of that used in the past to estimate comparative cost and incentive indicators for a number of African countries.[7] The original methodology emphasizes the calculation of ***domestic resource costs*** **(DRC)** as an indicator of comparative costs and of ***nominal*** and ***effective rates of protection/subsidy*** **(NRP** and **ERP/ERS)** as measures of incentives. These indicators have served in many countries as an important input into decisions related to programs of structural adjustment and policy reform.

The ***domestic resource cost*** **(DRC)** is an indicator of the efficiency with which a country's factors of production are converted into a product. More precisely, the **DRC** for a particular productive activity is equal to the ratio of the value of nontradable such as labor, land, and capital, and the difference between the reference price of the final good and the total value of tradable, such as machinery, fertilizers, and phytosanitary products, all measured in reference prices.

$$DRC_j = \sum \frac{f_{sj} P_s^*}{P_j^* - \sum a_{ij} P_i^*}$$

where f_{sj} is a technical coefficient relating nontradable primary factor s to output j,
a_{ij} is a technical coefficient relating tradable intermediate input i to tradable output j,
P_s^* is the opportunity cost of factor s,
P_j^* is the reference price of output j, and
P_i^* is the reference price of input i.

If this ratio is less than one, then more value is created than is used up in production, and the country has a comparative advantage in this activity; if the ratio is greater than one, the country has a comparative disadvantage.

[6] See Douglass C.North, "Institutions," *Journal of Economic Perspectives*, 5(1), Winter 1991.

[7] For an extensive discussion of the EP/DRC methodology, see J. Dirck Stryker, B. Lynn Salinger, Jeffrey C Metzel, and Elaine Tinsley, *Comparative Costs and Incentives Analysis: A Methodological Handbook*, Associates for International Resources and Development, April 1993. The agricultural sector in Madagascar is analyzed using this methodology in J. Dirck Stryker, Jeffrey C. Metzel, and Ashley S. Timmer, *Regional Specialization and Agricultural Growth in Madagascar*, report prepared for the UNDP and the World Bank, Strengthening of Planning Capacity and Economic Management Project, by Associates for International Resources and Development, December 1992.

While the **DRC** indicator is related to the theory of comparative advantage, the ***nominal rate of protection*** **(NRP)** refers to the structure of incentive involving international trade, namely: import duties, export taxes, quantitative restrictions on imports, etc…) The nominal rate of protection is the ratio of the domestic price of a product to its reference price, converted to its import tariff or export tax rate equivalent by subtracting one.

$$NPR = \frac{P_j}{P_j^*} - 1$$

where Pj is the domestic price of output j,
Pj* is the reference price of output j, and
Pj/Pj* is the nominal protection coefficient.

The **NPR** and **NPC** measure the degree to which consumers are either taxed or subsidized by trade policy. If the **NPR** is greater than zero (NPC >1), consumers are being taxed because they are paying prices that are higher than those paid on the world market. If the **NPR** is less than zero (NPC<1), consumers are being subsidized vis-à-vis the world market.

The shortcoming of the **NPR** is that it only takes into consideration the price of the final product, while economic and sector-based policies also greatly influence the price of inputs. Thus, the effective protection coefficient that affects the prices of both outputs and tradable inputs is a better indicator of protection offered to producers. The ***effective protection coefficient*** **(EPC)**, which measures value added in domestic prices relative to value added in world prices is:

$$EPC_j = \frac{P_j - \sum a_{ij} P_i}{P_j^* - \sum a_{ij} P_i^*}$$

The ***effective rate of protection*** **(ERP)** is obtained by subtracting one from the **EPC** (ERP=EPC-1). If **EPC** is less than 1.00 (ERP<0), producers receive negative protection, i.e., the structure of tariffs and other trade distortions places producers at a comparative disadvantage in world markets. The ***effective rate of subsidy*** corrects the **EPC** for taxes and subsidies on nontradable inputs.

The extension of this methodology involves estimating the costs of various institutional constraints. These costs are categorized according to whether or not they may be interpreted as an implicit tax or subsidy on tradable or nontradable goods and services, or, alternatively, whether they are part of the real economic cost of doing business. For instance, long delays in clearing exports or imported inputs through customs have costs that can be measured in terms of unnecessary fees, opportunity cost of the capital immobilized, and wasted time in dealing with administrative procedures. All of these act effectively as a nontariff barrier, which can be converted to its equivalent tax on exports or tariff on tradable inputs. Similarly, firms that are unable to obtain financing through the formal banking system may have to borrow from the informal sector at much higher rates of interest. If bank credit is unavailable because the government is crowding out the private sector in its demand for credit, then the higher interest charges may be considered as a tax on nontradable capital due to government policy. On the other hand, if the firm is unable to borrow because it is undercapitalized or considered a bad credit risk, given the poorly developed capital market, then the additional charge should be considered as a real cost of doing business.

Institutional costs in the calculations include both direct costs (e.g., unnecessary fees) and imputed costs (e.g., administrative effort to satisfy requirements, opportunity cost of tied up capital, losses associated with inability to convert foreign exchange at the best rate of exchange). In principle, they could also include the cost of having to go to the informal sector (e.g., higher cost of capital, limitations on economies of scale, lower quality of labor) and the risk associated with discretionary government intervention, illegal activities, and other sources of uncertainty. In practice, however, it has not yet been possible to measure these. Once institutional costs are estimated and categorized, a revised set of comparative cost and incentive indicators is estimated, <u>inclusive of institutional costs and incentives</u>.

It is important to underline that the distinction between the costs associated with discretionary policies and those that are related to the level of market development is somewhat arbitrary but nevertheless critical. The former may be seen as influencing private profitability, but not economic costs, whereas the latter are part of the total costs that must be considered in deciding whether exports are profitable. For example, one important factor in East Asia's success in expanding nontraditional exports has been a policy environment that permitted duty-free admission of imported inputs used in the production of exports. Yet, as this study has shown, it has been difficult to establish such a system in Africa that is free from cumbersome, arbitrary, and often discretionary procedures. Despite these problems, however, we believe that an efficient and transparent system of duty relief can be put in place in Africa, and we therefore treat the absence of such a system as a policy constraint capable of being overcome.

Although it has been tempting at times to compare Africa with Asia as a baseline in determining whether a particular institutional constraint should be treated as a disincentive or as a real cost of doing business, we have resisted this impulse and have instead tried to use either best practice in Africa or, as in the previous example, that which appears feasible with a reasonable amount of sustained effort. In this respect, we have tended to use experience with horticultural exports from Kenya and manufactured exports from Mauritius as a baseline, even if this seems to be just out of reach of most African countries. But as one managing director from Mauritius of a garment firm in Madagascar put it, "All the problems that currently exist in Madagascar also existed in Mauritius twenty years ago. You just have to keep chipping away at them."

A number of additional steps were originally envisioned in the methodology but were not attempted because of data limitations and because of the desire to limit the results, for the moment, to those that could be most solidly substantiated. For example, to estimate the overall magnitude of costs resulting from each institutional constraint, a calculation could be made of the difference between the level of exports that actually exists and that which could be achieved if this constraint was eliminated. Assuming that world demand is not the primary constraint on exports, this implies arriving at some estimate of the supply function for each product. Once the export gap is calculated for each product, the results could be aggregated and the total loss of exports, and even of GDP, could be estimated for each constraint.[8] The constraints could then be ranked according to their contribution to the loss of exports and of GDP. Finally, some attempt could be made to estimate the costs associated with reducing or

[8] It is important to recognize that once allowance is made for the reallocation of resources resulting from the elimination of one or more institutional constraints, the partial equilibrium model implicitly assumed here becomes less appropriate because of the general equilibrium effects that take place. This is a common problem for any policy analysis, however, and is in no way unique to the estimation of aggregate losses associated with institutional constraints.

eliminating the most important institutional constraints, even if this could only be done qualitatively. These additional steps are discussed later in the section on recommendations for future research.

As mentioned earlier, the methodology presented here has been tested in Ghana and Madagascar. The detailed results for both countries are presented in a separate discussion paper. In this paper, a brief summary of the results for each case study is presented in the following sections, before entering into the comparative analysis discussion. In both countries, firms surveys were conducted in order to identify and measure the institutional constraints facing nontraditional exporters. Neither of the firm samples was randomly selected or large enough to permit broad conclusions about exporters in Ghana or Madagascar.[9] However, the results are highly suggestive of what is likely to be found for a broader sample of firms.

II. RESULTS SUMMARY FOR GHANA

In Ghana, 44 firms were surveyed. Nine different industries were represented and included horticulture; textile and garments; wood products; and processed foods. Indicators of domestic resource costs (DRC), nominal rates of protection (NRP) for outputs and inputs, effective rates of protection (ERP), and effective rates of subsidy (ERS) were calculated applying the standard methodology and using data acquired during the survey. These indicators were then adjusted for institutional costs that were identified and measurable for all interviewed firms.

Most of the adjustments involved calculating the implicit export tax rate that results from (1) the imputed cost of unnecessary labor involved in processing export shipments, (2) the unnecessary cash costs involved in processing exports, including fees paid to organizations which rendered no services, and (3) the cost of having to convert 65% of foreign exchange earnings through the banking system rather than through the foreign exchange bureaus. The labor and cash costs associated with complying with unnecessary procedures were subtracted from the cost of nontradables.

An implicit tax on imported imports was calculated on the basis of (1) the imputed cost of unnecessary labor involved in processing import shipments, (2) the unnecessary cash costs involved in processing imports, and (3) the imputed capital costs resulting because of the delays in processing imports. These costs were subtracted from the cost of nontradables and were considered instead as a tariff equivalent on imported inputs.

The results of the analysis show that implicit export tax rates resulting from the institutional barriers such as delays in processing exports and unnecessary fees, are not very important, but they are nonetheless significant. For most firms for which it was available, the implicit tax was at least 2.9% of the FOB value of export sales because of these barriers. Since there are no formal export taxes, the nominal rate of protection for output is zero for all firms but the adjusted NRP was -3% for most. In certain case however, the implicit export tax was as high as 16.2 %, showed by an adjusted NRP of -16%.

The DRC results suggest that most of the products being exported are profitable (DRC<1), and some are highly so. This is especially true after adjustments is made for the costs of institutional constraints. These adjustment include: (1) correcting the value of export sales for undervaluation due to the lower rate at which 65% of export earnings had to be converted into cedis, and (2) subtracting out the costs of labor and capital associated with institutional constraints that can be removed.

[9] Firms were identified by personal contacts and selected on their propensity to cooperate.

The unadjusted NPR for inputs is positive and much higher, ranging from 5% to 39%. This is because of the lack of a workable system of exemption for taxes paid on imported inputs and services used by exporters. The adjust NPR differs little from the unadjusted.

The net result of all of these factors is relatively high negative adjusted rates of effective protection and effective subsidy. The adjusted ERP, varied from -8% to -40%. The value of this indicator depends mostly on the importance of institutional constraints affecting output incentives, the weight of imported inputs in total production, and the rate at which input are taxed. In sum, with few exceptions, the results suggest that exports are heavily penalized by a combination of institutional constraints and taxation of imported inputs. This is strong contrast to import competing products, with enjoy ERPs in excess of one. Thus the bias against nontraditional exports is very important and needs to be taken into consideration in policy discussions.

Nontraditional markets are highly competitive, and the competitiveness of a product depends also on keeping the production costs to a minimum. An equivalent export tax of 5% to 15% can jeopardize the life of an industry. Because of the difficulty of collecting a substantial portion of public revenue from direct taxes in Ghana, like in most Africa, a high tariff structure which penalizes importers will remain for sometimes. Which is why, for nontraditional export to strive, it is imperative that all other impediments to export trade be minimized.

III. RESULTS SUMMARY FOR MADAGASCAR

In the case of Madagascar, the sample included 34 firms. The sectors represented included: marine products; horticulture; artisanal goods and semi-precious stones. The indicators computed for Ghana were also determined for Madagascar.

The survey results indicated that the real costs of doing business in Madagascar are enormous. They derive from inadequacies in the domestic transportation and telecommunications infrastructure, lack of depth in the financial sector, and shortcomings of the judicial system. These constraints can only be addressed in the long-term or at best in the medium term and would require considerable investment.

With regards to institutional constraints amenable to policy change in the short-term, firms have identified 5 majors areas of concern. The first is foreign exchange access and accounts for about 3 to 10 % of total FOB sales. The second is custom clearance; customs and shipping delays amount to 15 to 25% of total sales FOB. The air freight monopoly comes third on the list and can costs as much as 8 % of FOB value of sales. Finally, the costs associated with fees and tips come last and range from 0.04% of total sales FOB to about 1%.

Most of the firms surveyed, operated efficiently by world standards, they had a DRC less than one. Once institutional costs are extracted, the average decline in the DRC coefficient across exporting firms is 0.045, showing again a strong bias against exports.

For the firms surveyed, the implicit tax rate resulting from institutional costs varies from a low 3.3 % to a high 37.8%, with more than 10 firms reporting an implicit export tax in excess of 10%, which suggest substantial export disincentives. The adjusted NRP on output varies from -3% to -38%.

The NRP on inputs varies from 2% to 48%. This is a major barrier to exporters of products that use substantial amounts of imported inputs in their production. The situation is even worse for most firms once institutional costs are taken into account.

The combined effects of negative protection on output and positive protection on imported input give rise to effective rates of protection that 0% to -21%. Adjusting the EPC for institutional costs results in a substantial increase in the degree of negative protection. The range of adjusted ERP is -4% to -44%. The ESC follows a similar pattern. This has to be compared with high positive rates of effective protection, ranging from 30 to 50%, enjoyed by import competing firms simply because of the level and structure of tariffs used for revenue purposes.

IV. COMPARATIVE ANALYSIS

On the basis of these results and the experience of other countries[10], it is possible to draw some interesting comparative conclusions and to formulate some hypotheses regarding the relevance of these conclusions for other countries. Most of these conclusions relate to the institutional environment that exists in Africa and the kinds of distortions in incentives that it creates. These distortions must be considered, however, in relation to the kinds of products that are being exported and the evolving nature of Africa's comparative advantage. They must also be seen within the light of the demands placed upon exporters by today's competitive world markets and the bias against exports inherent in most African economies.

A. Africa's Evolving Comparative Advantage

For many years, Africa's comparative advantage has been seen as being based principally on traditional primary products. This is because the natural resources used to produce these products were thought to be abundant relative to supplies of labor and capital. It was to Africa's advantage to exploit these "surplus" resources in order to maximize its national income and earn the foreign exchange required for investment in further economic growth.[11]

Although this dimension of comparative advantage is far from exhausted in most African countries, it is pretty much exhausted in some, and in others the prospects for this sector serving as the motor of growth in the future are dim. In some instances, this is because world market opportunities are

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[10] Tyler Biggs et al., "Africa Can Compete! Export Opportunities and Challenges in Garments and Home Products in the U.S. Market," Regional Program on Enterprise Development Discussion Paper, World Bank 1993. U.S. Agency for International Development, Bureau for Private Enterprise, *Financing Non-Traditional Exporters in Ghana; Assessment of Needs and Recommendations for USAID Assistance*, Final Report, prepared by First Washington Associates, Ltd. for USAID/Ghana, March 1992, p. 14, and data from the Ghana Export Promotion Council. Industrial and Management Services Limited (IMAS), Final Report on Bureaucratic Constraints within the Non-Traditional Export Sector in Ghana, prepared for USAID/Ghana, June, 1992. Samuel Paul, Assessment of the Private Sector, A Case Study and Its Methodological Implications, World Bank Discussion Papers 93, 1990, p. 29. Nural Islam, *Horticultural Exports of Developing Countries: Past Performances, Future Prospects, and Policy Issues*, International Food Policy Research Institute, Research Report No. 80, April 1990.

[11] This phase of development corresponds to what Hly Myint has called the "vent-for-surplus" period of economic growth. Hly Myint, "The 'Classical Theory' of International Trade and the Underdeveloped Countries," *Economic Journal*, Vol. 68, 1959, pp. 317-37.

limited. This is the case with cocoa, for example, for which growth of world demand is relatively slow, and competition among suppliers has become increasingly fierce. In other instances, demand constraints are less important than those of supply. This is true, for example, of declining timber reserves in many African countries.

At the same time that the prospects for traditional export growth are declining for many African countries, there are new opportunities in the area of nontraditional exports. One example is the growth of demand in the richer nations for tropical fruits and vegetables, which now occupy a special section in many supermarkets. Another is the expansion in the marketing of Afrocentric products to include a number of department store chains. Third, though exports of timber are declining in many countries because of supply constraints, those of processed wood products are rising because of ready access to cheap labor and raw materials and because demand for high quality hardwood furniture, builders materials, and other products is rising. Finally, a number of African countries are beginning to be taken seriously as sources of cheap, but efficient, labor for the production of standardized products, such as garments, that are produced using labor-intensive techniques.

The cases of Ghana and Madagascar are illuminating in this respect. Each country has the ecological conditions that permit it to export a number of products for which production is intensive in the use of natural resources. For both countries, these include horticultural crops, seafood, and wood products. With its rich variation in ecological and geological conditions, Madagascar also has a substantial comparative advantage in the exportation of spices, legumes, rice, livestock products, fibers, medicinal plants, and semi-precious stones. Ghana, on the other hand, is in reasonably close geographical proximity to Europe, which gives it a comparative advantage in exporting products such as pineapples. Likewise, Madagascar benefits from being in the southern hemisphere, with access to the South African and Indian Ocean markets and with the capability of producing winter season crops.

The two countries also have similarities and differences with respect to their comparative advantage in the production of manufactures for export. Each country appears to have an advantage in the production and export of standardized labor-intensive goods, such as garments, though this is only beginning in Ghana, whereas Madagascar has several years of experience and wage costs there are somewhat lower. (reference to the other discussion paper). There is also the question of whether investment in the garment industry in these two countries is being undertaken primarily to avoid the restrictions of the Multifibre Arrangement (MFA) rather than to take advantage of low labor costs. However, although avoidance of these restrictions is undoubtedly a benefit, there is also evidence that unit labor costs in the production of standardized garments are sufficiently low in Africa to be competitive with regions of low labor cost in Asia.[12]

There are two areas in which Ghana appears to have a comparative advantage over Madagascar. One is in the export of Afrocentric products, where African origin is a key element in marketing. The major question here is how deep this market is, especially if a large number of African countries begin exporting to it. The second area is exports by Ghana of manufactured goods overland to neighboring countries. In the recent past, these exports may have been substantially inflated because of the overvaluation of the CFA franc. On the other hand, because of proximity and low transportation costs, there is probably scope for some level of intraregional trade within West Africa beyond that which is based on clear lines of comparative advantage, such as Ghana's exports of salt.

[12] Tyler Biggs, *et al*, "Africa Can Compete!..."

How can this comparative analysis be applied to other countries? There are several hypotheses that can be generated. The first is that most countries have a comparative advantage in a number of different types of nontraditional exports based on ecological and geological conditions, pools of low cost labor, rich cultural history, proximity to neighboring markets, and other elements. Very often the absence of one element underlying a country's comparative advantage implies the presence of other elements. In Madagascar, for example, the areas that are particularly rich ecologically produce the spices, tropical fruits, medicinal plants, seafood, and other natural resource based products that are exported, while the labor used in the production of garments comes primarily from the highlands, where population pressure on the resource base is high and wages are low.

A second hypothesis is that most African countries have products that they can export for which comparative advantage is sufficiently high that they do not have to be extremely competitive on world markets. This is particularly true of the products for which comparative advantage is based on ecological or geological conditions or on cultural history. These are the products that the firms of a country can export while they are learning to become more competitive in terms of their packaging, quality control, and timeliness. With their competitive edge assured by geography or history, they can afford to make some mistakes during this period before they embark on the more difficult standardized products for which competition is much keener.[13]

B. Competition in Today's World Markets

As the world economy becomes more integrated and demanding, countries must compete with each other not only in terms of price but also in terms of quality and timeliness. In today's competitive market, lower price is not as easily substituted for lower quality as in the past. Legislation and the trend toward standardized products have made quality control an important element in buyers' decisions. African firms need to implement management measures that will guarantee the quality of their goods. This task should not be the sole responsibility of the individual firms, but also of the professional associations and other quasi-public groups as well. Countries tend to have a general reputation for their goods rather than a reputation for the goods of specific industries. Therefore, unless there is a general positive consensus concerning the quality of a country's goods, it is harder to attract buyers or to receive a premium on quality products.

Particularly for manufactured exports, quality control permits standardization, which in turn allows small firms to obtain economies of scale by sub-contracting or being sub-contracted. Since African firms are characteristically small and often do not have the capital requirements to expand production in order to meet large exporting orders, sub-contracting provides a means of exporting despite fixed capital constraints. Small firms are likely to be more successful specializing in one part of the product chain rather than struggling with the entire production process. Therefore, standardization of product and manufacturing processes ensures these firms of greater compatibility with outside firms and products.

There are two components to timeliness: the production cycle and the distribution cycle. For the most part, the firm has almost complete control of the production cycle; however, for items such as

[13] This idea extends that of Nural Islam, referred to earlier, by broadening beyond horticultural crops the range of goods that serve as a natural bridge to exports of manufactured goods. Islam, *Horticultural Exports*

imported inputs, the firm can be vulnerable to outside influences. The distribution cycle, though partially in the firm's realm of control, is more a reflection of the country's infrastructure and its ability to expedite transactions. The shorter the time period for these two cycles, the more the firm has control over the chain of events and the better the firm's response time to its clients.

From an importing firm's point of view, one of the key constraints on doing business in much of Africa is inadequate telecommunications. The situation today is, in fact, appalling in many countries with respect to both internal and external communications. In this day and age of instantaneous communications, there is little tolerance for delayed responses. Yet many firms in Ghana and Madagascar still use messengers as a major means of basic communication. Without improved telecommunications, African firms must continue to depend on established informal trading relationships versus relationships created through formal networking or advertising, since these latter relationships often require more proof of legitimacy because the parties are unknown to each other. Lack of direct, expedient communication seriously undermines this legitimacy.

Aside from business contacts, adequate telecommunications can shorten production cycles. If firms are aware of a delay, they can take action to prevent it, e.g. ordering inputs from another supplier, rather than waiting through the delay. Reaction and turn around time is reduced. Electronic data transfers also reduce the time spent on communicating orders, shipping, and payment information.

Investing in quality control and time-saving infrastructure and operations pays off. These two attributes attract buyers, who generally want long-term relationships with only a few suppliers to keep transaction costs and response time down. In fact, some 46% of transcontinental trading relationships are more than 10 years old. African firms can benefit from cooperation with foreign firms in terms of gaining technical and marketing exposure.

The distribution cycle entails the infrastructure which the supplier must work with. Just-In-Time (JIT) manufacturing methods are increasingly being desired, which means cuts in transportation time are important. Transport infrastructure systems in Africa must be improved to support this need. Buyers are interested in moving stock quickly -- instead of having a 6-week stock, now they only want 1.5 weeks worth. This translates into suppliers having to make more frequent and smaller shipments, increasing the burden placed on transportation infrastructure.

C. Bias Against Exports

In view of this highly competitive world market, exploitation of Africa's evolving comparative advantage in nontraditional exports is seriously impeded today by the strong bias that exists against exports. This bias occurs for two major reasons. The first is overvaluation, which creates a bias against exports in favor of nontradables. Although both Ghana and Madagascar have reduced the overvaluation of their currencies enormously by eliminating most controls on imports and foreign exchange, there is still some overvaluation because taxes on imports allow balance of payments equilibrium to be maintained at an exchange rate that is appreciated in relation to the equilibrium exchange rate that would prevail if there were no import taxes. The second, somewhat related, bias occurs because import taxes tend to protect the import-competing sector, attracting resources towards this sector and away from the production of exports. Both the bias due to overvaluation and that which occurs within the tradables sector are, to a large extent, unintended by-products of taxes imposed primarily for revenue purposes. Yet it is difficult to reduce these taxes because governments in Africa do not have the administrative capacity to rely more heavily on direct taxes as a major source of revenue.

Subsidies and other measures to promote exports could be used to offset these biases. However even in the absence of the biases, a strong case can still be made for the active promotion of nontraditional exports based on the important benefits that may be derived by African nations from expanded international trade. The evidence continues to mount from other parts of the world, as well as from the experience within Africa, that economic growth is closely interlinked with foreign trade. Aside from the usual economic arguments associated with efficiency of resource allocation due to the exploitation of comparative advantage and economies of scale, there are a number of other ways in which trade contributes to economic growth. These include using trade and associated investment as a conduit for technological transfer, increasing the efficiency of enterprises forced to compete on foreign markets, expanding the commercial and managerial competence of entrepreneurs, augmenting the skills of the work force, creating a market for labor in the face of growing population pressure, increasing foreign exchange earnings that can be used to import capital equipment, and a host of other factors.

Assuming that trade is desirable, the question remains as to whether the benefits from trade accrue equally regardless of whether exports, especially nontraditional exports, are directed at overseas markets or to neighboring countries. Overseas markets present the advantage that their demand for nontraditional exports from Africa is relatively elastic (an hypothesis that needs to be tested), their contribution to the transfer of technology and managerial knowhow is potentially great, and the range of goods that may be exported is virtually inexhaustible. On the other hand, transportation costs can be considerable, standards of quality and timeliness of delivery are high, and contracts may be difficult for African exporters to enforce.

The data gathered from the surveys in Ghana and Madagascar throw some interesting light on this issue. Although firms with a larger value of total sales contribute the most to nontraditional exports, they do not represent the most dynamic element in the export sector. Instead, it appears that smaller, younger firms are more heavily specialized in exports and are more likely to find niche markets in the industrial countries, rather than simply expanding into neighboring countries as the older, larger firms have done. Ways should be found to facilitate linkages between these younger firms and foreign partners, which could play a vital role in helping them to penetrate overseas markets.

For these firms to survive successfully in this environment, however, it is critical that institutional constraints be reduced to a minimum. There may even be a case for providing preferential access to loans or some form of subsidization, as occurred in some of the East Asian countries.[14] In any event, the recommendations that follow should be seen in the light of trying to make nontraditional exporting firms as competitive as possible.

D. Legal, Regulatory, and Judicial Environment

The discussion in Chapter I Section B noted the importance of a legal, regulatory, and judicial environment that is propitious for the growth of nontraditional exports. It referred to Douglass North's work showing the development within northern Europe of institutions that reduced transactions cost by increasing mobility of capital, lowering information costs, and spreading risks. Fundamental to this institutional development were (1) limits placed on the arbitrary intervention by government in the market place and (2) legal and judicial systems that provided for the establishment and maintenance of property

[14] World Bank, *The East Asian Miracle*, Washington: 1993.

rights, the enforcement of contracts, and the resolution of liability disputes. This institutional framework permitted the emergence of complex impersonal forms of exchange that were essential to capture the economic benefits of modern technology.

The investigations conducted as part of the two case studies suggest that this type of institutional framework is sorely lacking in Africa. Prior to approval of Ghana's new constitution in 1992, administrative mechanisms rather than the rule of law were used to implement economic policy. This contributed to the short-term success of the structural adjustment program because it greatly simplified decision-making, but it also undermined the confidence of the business community and its ability to achieve judicial relief from government violation of property rights. This situation was exacerbated by the inability of the courts to keep up with the volume of litigation. As a consequence, the government created regulatory agencies such as the Ghana Investment Center to replace the statutes and independent courts in the protection of property rights and enforcement of contracts. This inevitably introduced a large degree of discretionary authority, which created uncertainties for potential investors. Although efforts are underway to reduce regulation, which is frequently perceived by the business community as being both excessive and arbitrary, the development of a legal and judicial system capable of taking its place will be a very slow process.

A similar situation exists in Madagascar, where numerous inadequacies of the legal and judicial system have been documented related to commercial law, dispute resolution, competition law, and judicial independence. The legal and judicial system is so entangled in inconsistencies, ill developed judisprudence, and misplaced discretionary authority, in fact, that it is widely perceived to be ineffectual and unreliable. The situation is severely aggravated by the political turmoil of recent years from which the country is only beginning to emerge.

Despite the inadequacies of the legal and judicial system perceived by the business community, few firms listed this as a serious constraint on the expansion of nontraditional exports. Instead, they have found ways of working around the system that involve personal relationships, family and school ties, political favoritism, and even outright bribery. Although this reduces the problems normally resolved in the advanced countries through the application of business law, it has two important consequences. First, as described by North, it reduces the scale of activities by preventing the emergence of complex impersonal forms of exchange. Second, it severely biases the incentive structure in favor of the rich and powerful, preventing the emergence of less advantaged, but potentially dynamic, smaller entrepreneurs. How important a factor this is in inhibiting the expansion of nontraditional exports, we can only guess, for the present. This is an important topic for future research, however, if substantial resources are to be devoted to improving legal and judicial systems in Africa.

During the period to which the survey applied, very few exporters noted examples of high level government interference in their business operations. Yet one would not have to go back many years to reach a period in each country when this type of interference was commonplace. One of the major problems of replacing a legal and judicial system with government regulation is the potential for widespread abuse. Without constraints on the use of its power, the executive branch of government has in many African countries interfered extensively and often arbitrarily in the business sector. Aside from the immediate harm that this causes, it also vastly increases perceived uncertainty on the part of the business community, and this may discourage investment for many years.

E. Institutional Distortions

In addition to the limitations and biases imposed by the lack of a viable legal and judicial environment in most African countries, there are a number of important distortions in the institutional structures of these countries that are inhibiting the expansion of nontraditional exports. A comparison of the institutional environments in Ghana and Madagascar reveal some important similarities, despite their varied colonial histories, but there are also substantial differences. The major constraints imposed by these environments on the expansion of nontraditional exports tend to be quite similar. These include (1) restrictions on exporters' retention of foreign exchange earnings, (2) lack of duty-free access to imported inputs, (3) slow and costly procedures for clearing exports and imported inputs, (4) lack of access to term finance for fixed investment, (5) lack of access by smaller firms to working capital, (6) problems in the implementation of special incentive schemes, (7) lack of competition for air and sea freight, (8) inadequate transportation and telecommunications, (9) excessively complicated or restrictive regulations regarding land and labor, (10) lack of qualified skilled labor and middle-level managers (11) and problems in contract enforcement with overseas importers. These problems are summarized here and their generalization to other African countries is in some cases assessed. Recommendations are subsequently offered as to what actions might be pursued.

1. Restrictions on Exporters' Retention of Foreign Exchange Earnings

Historically, the most important disincentive to exports, traditional as well as nontraditional, has been overvaluation of the exchange rate. During the early 1980s, the cedi in Ghana may have been overvalued by as much as 2400%.[15] Although overvaluation in Madagascar was never as great as this, it nevertheless posed formidable problems for the export sector from the mid-1970s until very recently.

Where exchange controls are in place, with exporters required to turn their foreign exchange earnings in to the banking system or exchange authority rather than being allowed to retain these earnings or to exchange them for local currency on the private market, the potential for an export disincentive exists. The severity of this disincentive depends on the difference between the rate at which exchange conversion takes place through the official, regulated market and the rate that exists on the private, parallel market that is found both within the country and offshore.

During the year to which the surveys in Ghana and Madagascar applied, 1992, the costs associated with controls on exporters' use of their foreign exchange earnings were higher than they are today, especially in Madagascar, where 100% of earnings had to be converted to local currency at an exchange rate that was quite unfavorable.[16] Exchange controls have now been substantially liberalized in Ghana, with exporters allowed to retain their earnings in foreign exchange accounts in Ghana. Exporters are still required to submit the Exchange Control Form A2 to their bank, however, which charges a fee equal to 1-1.25% of the FOB value of the shipment (0.5% of which goes to the central bank). The banks use this procedure to exercise some monopoly power over their customers when they convert part of their foreign exchange earnings into local currency to pay bills or for other reasons. This requirement is

[15] J. Dirck Stryker, *Trade, Exchange Rate, and Agricultural Pricing Policies in Ghana*, World Bank Comparative Studies, The Political Economy of Agricultural Pricing Policy, Washington: World Bank, 1990, p. 300.

[16] The degree of overvaluation of the FMG on the official market vis-à-vis the parallel market that was assumed in the comparative costs and incentives calculations was only about 10%. This was probably a considerable underestimate, even for that year. In the ensuing period, up to May 1994, this difference grew considerably, heavily penalizing Malagasy exporters.

substantially more liberal than in Madagascar, where Malagasy exporters today can retain only 10% of their earnings as foreign exchange. This requirement is highly discriminatory, moreover, since foreigners and firms in the *Zone Franche* need only convert what they need into local currency.

Because the rate of exchange at which exporters now obtain local currency in each country is determined today largely by the inter-bank market for foreign exchange, and this inter-bank rate does not differ very much from the rate on the parallel market, the cost of these remaining controls is not very great. Nevertheless, the potential for policy reversals induces uncertainty, which inhibits investment. Furthermore, the problem is much more acute in countries that have currencies that are seriously misaligned.

2. Lack of Duty-Free Access to Imported Inputs

Both Ghana and Madagascar suffer from lack of duty-free access to imported inputs despite the fact that each has formal mechanisms to provide this access. In Ghana, the most important mechanism is the duty drawback system, but it is seldom used. Efforts are underway to improve the effectiveness of this system by setting up a special fund, established by a USAID project, to speed the drawback process, but there is little experience with it to date. Procedures also exist for duty exemption and the maintenance of bonded warehouses, but these are available mostly to larger firms, and they tend to be fraught with discretionary authority that is subject to abuse. In addition, there is no systematic mechanism for duty-free admission of imported inputs used indirectly in the production of exports.

In Madagascar, the situation varies markedly depending on whether of not a firm is within the *Zone Franche*. Those that are approved under this scheme are able to import their inputs duty-free with relatively little administrative inconvenience. Although Zone status is open to all firms that export close to 100% of their production, in practice only those of a certain size generally apply and are approved. Firms outside the Zone that export more than 75% of their production can be exempted from taxes paid on locally purchased inputs, but the procedures are cumbersome and there is no relief for firms that export less than 75%. All firms are eligible for temporary admission without payment of taxes of imported inputs used in the production of exports, but in practice only the larger exporters use this procedure, which is subject to discretionary approval and considerable abuse.

The cost of not having duty-free access to imported inputs is considerable, especially for the firms that engage in the labor-intensive production of standardized goods made mostly of imported materials, such as the garment industry. In Ghana the nominal rate of protection (NRP) on inputs for the firms in the survey ranged from 5% to 39%. The NRP on inputs for 12 out of 17 firms was in excess of 15%. In Madagascar the NRP on inputs was even higher, ranging from 2% (a *Zone Franche* firm) to 49%, with 10 out of 14 firms having a NRP on inputs in excess of 20%. This factor alone resulted in an effective rate of protection (ERP) in Ghana ranging from -4% to -30% and an ERP in Madagascar of from 0% to -21%. Given the competitiveness that exists in world markets, especially for standardized products, and given the other biases against exports described above that are largely unavoidable, this level of negative protection resulting from taxation of inputs is intolerable if African countries are to succeed in expanding their nontraditional exports.

3. Slow and Costly Procedures for Clearing Exports and Imported Inputs

In each of the case study countries, exporters listed slow and costly procedures for clearing exports and imported inputs as a significant problem, despite the fact that major strides have been made in recent years in simplifying these procedures. One problem is that clearance of goods through customs becomes a convenient way of assuring that companies have complied with legal and tax obligations that have nothing to do with their trade activities. The most obvious example is the requirement in Ghana that companies obtain a certificate from the Internal Revenue Service showing that they have paid all of their income taxes each time that they process a shipment for export or import. In Madagascar, exporters are required to purchase a local export license, as a means of raising funds for local governments, despite the principle formally accepted that exports should be exempt from all taxation.

Another problem is the delays often experienced in clearing customs. These delays vary substantially from one exporter to another and depend on the personal relationships that have been established with particular customs agents. Tips often facilitate these relationships, but they are not a major cost. Not all companies are as adept in this process as are others.

A major problem is the special authorizations required from technical ministries before exports are allowed to clear customs. The procedures involved in exporting furniture and wood products from Ghana are particularly onerous, but the approvals required in Madagascar for exports of mineral products, wood products, and handicrafts also cause major delays. In a few cases, the failure or delay in gaining approvals has resulted in lost orders that have been very costly. Another problem is lack of coordination between customs and the technical ministries.

In both Ghana and Madagascar, exporters report that delays in clearing imported inputs are longer than those involving exports. This is even true of firms in Madagascar that are included within the *Zone Franche*. Despite this, for most companies the cost of these delays is less than the costs involved in clearing exports because most firms do not import many inputs. Nevertheless, these delays, which can last up to several months, can be critical if a firm is to meet its delivery schedule.

4. Lack of Access to Term Finance for Fixed Investment

Lack of access to term finance for fixed investment was cited by exporters in both countries as a major constraint on the expansion of nontraditional exports. This was somewhat paradoxical in Ghana because many firms there are operating well below full capacity, but much of the equipment that exists is old, outmoded, and in disrepair. This appears to be less true in Madagascar, where most firms are operating close to full capacity. One reason for this difference is that exporting firms in Ghana tend to be older than in Madagascar. Many firms in Ghana were established originally to supply the domestic market and are now exporting to neighboring countries, whereas most exporting firms in Madagascar were established after the initiation of reform, with the overseas export market principally in mind.

The major reason for lack of term finance is the poor state of development of each country's financial markets. Part of the reason for this has to do with the history of inflation, poor banking practices, and general economic malaise, which took its toll on the balance sheets of the banks and other financial institutions and has made them highly risk averse. Second, neither of these countries has yet established a macroeconomic environment that is sufficiently stable with respect to prices, interest rates, and exchange rates to reduce to reasonable levels the actual risks associated with term finance. Finally, the legal and judicial system functions so poorly that lenders have an extremely difficult time foreclosing on delinquent borrowers. As a result, commercial banks, merchant banks, and other lending institutions have preferred to confine themselves to lending working capital and to the purchase of relatively safe, and often high-yielding, government securities.

As a result exporters are dependent on their own sources of finance, which are generally quite limited, or on financing from a foreign partner, where one exists. Some efforts have been made by donors to provide term finance through special credit lines, but these have encountered difficulties in the face of inflation, depreciating exchange rates, and other disturbances. Furthermore, the administrative procedures involved with these schemes have been sufficiently long and complex and the requirements for borrowing have been so stringent that many exporters have either chosen not to participate or have been unable to do so.

Other efforts to facilitate investment in fixed capital have involved insurance, credit guarantee, and leasing companies. Experience with these is relatively brief, however, and much of that has been confined to the larger, better established firms, which have relative good access to capital from other sources as well.

5. Lack of Access by Smaller Firms to Working Capital

Although few firms listed lack of access to working capital as a major impediment to the expansion of exports, it is clear that this poses problems to smaller firms, many of which have had relatively little banking experience. Shipments by these firms are often relatively small, making it difficult to cover the cost of obtaining letters of credit, even if they knew how to go about obtaining these letters. Given their lack of credit experience, loans to these firms are considered risky, but the backing of these loans with collateral is difficult because of their lack of financial assets, problems with control of inventories, and legal difficulties in foreclosure on real property. Efforts are underway, in Ghana especially, to increase the availability of short-term capital to smaller exporters through partial credit guarantees, but there is not yet enough experience to evaluate these schemes.

6. Problems in the Implementation of Special Incentive Schemes

Both Ghana and Madagascar make extensive use of special incentive schemes for the promotion of investment. Madagascar also has the *Zone Franche* scheme to encourage exports, and the government of Ghana is considering introducing a similar scheme. Yet experience with these schemes has not been uniquely favorable. Because the schemes establish a separate set of incentives for firms that are approved under them compared with the tax and other incentives that are available to all firms (*droit cummun*), the institutions responsible for policing these programs have tended to take on a regulatory role rather than one that is essentially promotional. Furthermore, obtaining approvals under these schemes can be long and time-consuming, and there is often a degree of arbitrariness to the decisions that can lead to abuse. One of the most disturbing aspects of these schemes is that in practice, if not in principle, they are often biased in favor of foreign investment. In any event, it is unclear why investment or export incentives should be restricted to an subset of "approved" firms rather than be available to all firms that meet the requirements.

This appears to be increasingly recognized in both Ghana and Madagascar. In Ghana, the new investment code is to put much greater stress on promotion as opposed to regulation. The approval process is also to be simplified and accelerated. In Madagascar, the investment code is being revised to allow firms to receive benefits only after investments have been made. A *guichet unique* has also been established to facilitate the approval process by having all ministries and other agencies represented in one place. Experience to date with these innovations is very limited, but the question remains as to whether it would not be best to simply extend the benefits received under these schemes to all firms that meet the requirements regardless of whether or not they have been "approved".[17]

7. Lack of Competition for Air and Sea Freight

Many of the overseas transportation problems that Africa faces today result from lack of competition for air and sea freight. Much of this is due to the low volume of export activity, which prevents freight companies from bidding actively against each other on both freight charges and shipment delays. As an example, charter air freight planes often have to stop in several African countries in order to fly to Europe reasonably full. Furthermore, to reduce costs Ghana is served mostly by ships that are southbound, resulting in a voyage to Europe that can take 17 to 20 days. This leads to delays that result in damage to shipments, especially of horticultural crops. Madagascar faces similar anomalies. These problems should eventually be overcome as volume increases.

On the other hand, lack of competition can also be engendered by government regulation. The most obvious example is the state monopoly conferred on Air Madagascar/Air France in the shipment of air freight. This results in prohibitively high air freight rates for many exporters, leading to unused capacity and missed market opportunities. In addition, competition in coastal sea trade is limited by the requirement that vessels engaged in this trade fly the Malagasy flag.

8. Inadequate Transportation and Telecommunications

The importance of timeliness and quality control in today's export market was emphasized above. The ability to assure these depends very much on a country's transportation and telecommunications infrastructure. Orders need to be accurately received and acted on quickly, and goods of proper specification and quality need to be delivered to the importer on time. Often windows of market opportunity are open for only a short period, and unless they can be exploited quickly, they are lost.

Most African countries do not have the transportation and telecommunications infrastructure that is necessary to meet this requirement. As a result, importers are reluctant to place orders with exporters that they perceive as being less than fully reliable. This is already a problem for exporters of primary resource based and Afrocentric products. It will become even more acute as exports expand of standardized products, for which timeliness and quality control are especially important competitive elements.

9. Excessively Complicated or Restrictive Regulations Regarding Land and Labor

The two country case studies highlight the cumbersome and complex regulations that exist regarding the use of land and labor. Land registration is often made complicated by the juxtaposition of customary and modern systems of land tenure. The failure to comply with all registration requirements can be extremely costly and long delays are frequent. The system of land registration established in Ghana in 1986 was designed to provide transparency, speed, and timeliness in the handling of matters concerning acquisition. Problems remain, however, because of the failure to publicize clearly the procedures to be followed in registration. In Madagascar, the situation is even worse. Foreigners may not own land, and the process by which nationals may acquire title is fraught with obstacles.

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[17] In 1997, Madagascar abolished its "*Code des Investissements*" in an effort to reduce the biases against domestic producers. Efforts are underway to include any special incentives into the revise "*Droit Commun*".

Both domestic and foreign-owned Firms in Ghana must go through the Ministry of labor for recruitment of personnel, rendering the hiring process lengthy and uncertain. Retrenchment of workers must be negotiated with unions and powerful political groups, often making it a very difficult process. Similar difficulties confront firms in Madagascar, though those approved under the investment code and *Zone Franche* are often exempt from these requirements. Many companies in both Ghana and Madagascar skirt the labor regulations by hiring mostly temporary labor.

10. Lack of Qualified Labor and Middle-level Managers

Lack of qualified semi-skilled labor and middle-level managers is a perennial problem in countries such as Ghana and Madagascar, which are embarking on the production of new products for export. Government technical schools are not generally a good solution to this problem because the training provided by them is often not what is needed. It is better if the training can be undertaken by the private sector. Frequently, foreign partners can provide assistance. To some extent, training is accomplished within individual firms, but there are obvious spillovers since much of the training is not very firm specific. Consequently, there is a case for the government to find some means of supporting training undertaken by professional associations or individual firms when that training applies to the industry or the economy as a whole, as well as to the needs of the association or firm.

11. Problems in Contract Enforcement with Overseas Importers

A number of firms complained about occasional problems in the enforcement of contracts with importers overseas. This was particularly true in the horticultural industry, where exports are frequently made on consignment due to the perishable nature of the product. It is often difficult for a firm to dispute an importer concerning the poor condition of the product on arrival and the consequent discount made on the payment to the exporter. But this is a common problem with world trade in agricultural products. It is usually resolved by engaging a reputable surveyor to assess the damage and to recommend adjustments in payments or insurance claims.

V. RESEARCH CONCLUSIONS AND POLICY RECOMMENDATIONS

A. Conclusions

There are a number of important conclusions for research that emerge from the application of the methodology described in Chapter I Section C and they are discussed here. The first conclusion is that it is possible to measure quantitatively some, if not all, of the costs associated with institutional barriers to the expansion of nontraditional exports and that these costs are considerable even in countries that have undertaken fundamental economic reform. The costs that were successfully measured in Ghana and Madagascar are those related to (1) controls on exporters' use of foreign exchange earnings, (2) lack of workable procedures for duty-free admission of imported inputs, and (3) unnecessary administrative delays and procedures involved in the clearance of exports and imported inputs.

The net effect of these costs is very substantial for many firms. An unweighted average of effective rates of protection resulting from these costs equals -18.8% in Ghana and -18.6 in Madagascar. This is a very high rate of negative protection for firms trying to compete in the world's export markets, even before taking into account the additional bias against exports resulting from overvaluation of the exchange rate and positive protection for the import-competing sector. Thus application of the methodology to even this limited range of institutional barriers reveals their importance.

There are a number of other costs associated with institutional constraints that have not been measured. These include lack of access to capital, problems in the implementation of special incentive schemes, lack of competition for air and sea freight, effects on quality and timeliness resulting from inadequate transportation and telecommunications, excessive regulations regarding land and labor, lack of qualified labor and managers, and problems in contract enforcement with overseas importers. There is also the bigger issue of the weak legal and judicial systems that characterize the entire African continent.

The reasons for the difficulty in measuring the costs associated with these constraints are several. In some instances, such as lack of access to capital, it is not clear how much the problem is due to fundamental factors related to development and how much it is due to impediments amenable to policy change. In other instances, such as the problems linked to special incentive schemes and to the regulation of land and labor, not only are the costs difficult to measure but also it is hard to determine to what extent these costs impede the expansion of nontraditional exports. Finally, as with the problems of contract enforcement reported by exporters, it is not always clear to what extent real costs are involved or there is simply the need for better information.

As mentioned in Chapter I, a number of steps were originally envisioned in the methodology that were not carried out because of data limitations and because of the desire to limit the results to those that could be most solidly substantiated. One such step was the estimation of supply functions for each export product studied and the calculation of the impact of each major constraint on the total quantity and value of these exports. The major difficulty involved in this calculation would have been the estimation of supply functions, given the lack of data on costs of different firms and on the potential for expansion in each industry. Were some of these data to be gathered at the industry level, this calculation could be made. In the meantime, we could gain at least some indication of the potential losses resulting from each constraint by examining the data that lie behind the comparative cost and incentive indicators discussed in the results summary sections and presented in more detail in the other discussion paper.

Finally, we have not yet tried to measure quantitatively the costs associated with <u>removing</u> institutional barriers to nontraditional exports. We have made qualitative assessments, however, in deciding whether a barrier should be treated as a real cost or as an institutional cost amenable to policy change. In addition, once a cost has been identified as institutional, recommendations have been made regarding its removal, though the costs of this removal, which may be largely political in nature, have not been assessed.

Despite these limitations, the research methodology is sufficiently developed that it can be extended fairly easily to other African or, for that matter, non-African countries. This should normally require about one month initially to review documentation, interview knowledgeable public officials and business people, and set up the survey of exporting firms. The survey can be conducted and analyzed and the draft report can be prepared during the ensuing three months, after which a second visit to the country should be scheduled to discuss and verify the results and to gather any further data. The final, revised report should be available within six months of the project's initiation. This report would identify the major institutional constraints on the expansion of nontraditional exports and would estimate the quantitative importance of the costs associated with those constraints. It would also make specific recommendations regarding policy changes that can be implemented in the short to medium term, as well as discuss longer term impediments to trade that need to be resolved.

B. Policy recommendations

1. Restrictions on Exporters' Retention of Foreign Exchange Earnings

The potential danger that results from controls on exporters' retention of foreign exchange earnings are enormous. Given the biases against exports that are unavoidable, because of the need to raise public revenue by taxing imports, it is imperative that exporters be given every encouragement possible. This has been a significant lesson of the experience in East Asia, and it needs to be transferred to Africa. Where countries such as Ghana and Madagascar have moved their exchange rates to realistic levels and have in place mechanisms to make swift exchange rate adjustments, there is nothing to be gained by maintaining controls on exporters' earnings of foreign exchange. These should be totally eliminated. Experience has shown that this does not result in a massive flight of capital. Rather, exporters are encouraged to repatriate their foreign exchange earnings in order to pay their recurrent cost obligations and finance new investment.

In other African countries, and especially in those of the CFA franc zone, no mechanism for automatic exchange rate adjustment exists. This creates problems if the local currency becomes overvalued, as the CFA franc did prior to January 1994. There is then a tendency for the central bank or exchange authority to try to hoard as much foreign exchange as possible, usually resulting in a tightening of controls on exporters' retention of foreign exchange. While there may be cases in which a fixed exchange rate can be maintained without some form of exchange control, the record to date in Africa is not encouraging. It remains to be seen whether the CFA devaluation in January will be sufficient to avoid some form of exchange control for exporters in these countries. Elsewhere, at least, it seems clear that elimination of controls on exporters' earnings of foreign exchange must be closely linked with the maintenance of a realistic exchange rate.

2. Lack of Duty-Free Access to Imported Inputs

Procedures for granting duty-free access to imported inputs must be made more automatic, must reduce the discretionary authority of public officials, and must eliminate the bias in favor of large firms and firms that export most of their production. Fortunately, this is becoming increasingly possible as customs processing is becoming more computerized. With full computerization, it will be possible to maintain records on the history of imports and exports of individual companies. Sets of coefficients can be constructed, by firm or by industry, indicating the import content, both direct and indirect, of exported goods. Using a formula based on past export history, firms could be granted temporary duty-free admission of imported inputs up to a certain limit. Verification would occur when the final products were exported. If exports by the end of the year were insufficient to justify the duty exemptions granted, the firm would be liable for back taxes, and its duty-free admission limit would be lowered by the formula. Beyond this limit, firms would have access to drawback of duties paid on imported inputs once the final products were exported. A similar system could be used for excise, value-added, and other indirect taxes paid on inputs, whether imported or purchased locally.

Systems such as this have been used in East Asia and elsewhere for several years. It would be very useful to examine the experience with these systems in order to determine how well they work and what problems have been encountered. But it is also important to bear in mind that what has worked well in Asia might not work so well in Africa. Thus it is important to monitor the experience in Africa as governments try to come to grips with the problem of providing duty-free access more systematically and to a broader range of firms.

3. Slow and Costly Procedures for Clearing Exports and Imported Inputs

Detailed recommendations are presented in the case studies regarding the elimination of unnecessary export procedures. Approval of technical ministries should be required only to assure that health and safety standards are adhered to, as is the case with food products. Every effort should be made to publicize widely the requirements that exist and to assure that these are as simple as possible. Computerization is essential to speed the process. It may also be necessary to hire more customs agents.

4. Lack of Access to Term Finance for Fixed Investment

Over the longer run, a market for term finance will develop spontaneously in Africa as financial systems become stronger and deeper. It is unclear how much this process can be accelerated without substantial subsidization, which most African countries cannot afford. Furthermore, subsidized credit schemes inevitably involve discretionary decisions regarding who has access to loans, and this runs counter to the general tenure of financial reforms, which has been to make lending more transparent and automatic as long as borrowers are willing to pay market rates of interest. Nevertheless, there may be ways in which term financing can be facilitated through the exploitation of economies of scale and diversification involved in such activities as leasing, insurance, and loan guarantee. These financial innovations should be strongly supported.

In the final analysis, however, the most effective way for governments to encourage the development of a market for term finance is through the maintenance of macroeconomic stability. Low rates of inflation, positive real rates of interest, and a stable exchange rate reduce the risks associated with financial intermediation and help to assure the financial viability of borrowers, making term finance more attractive to lending institutions.

5. Lack of Access by Smaller Firms to Working Capital

Insurance and loan guarantees may also play a useful role in helping small firms to gain access to short-term credit for working capital. Equally important, these firms need assistance in establishing banking relations, filling out loan applications, setting up accounting systems, and learning about other commercial and financial practices that are required if they are going to enlarge their scale of export operations. Frequently, this type of assistance can be incorporated into projects for the promotion of nontraditional exports, such as the Trade and Investment Program project in Ghana.

6. Problems in the Implementation of Special Incentive Schemes

The trend in both Ghana and Madagascar is towards making special incentive schemes such as the investment code or *Zone Franche* more promotional and less regulatory, simplifying and accelerating the approval process, and providing benefits after, rather than before, requirements have been met. The next step would be to incorporate these incentives directly into tax and other codes so that they would be available to all firms that met the requirements rather than just those that are approved. This would allow the agencies responsible for administering these schemes to become truly promotional. By definition, this approach would also eliminate delays and costs incurred in obtaining approval and would be based on *ex post*, rather than *ex ante*, justification. Most important, this approach would eliminate most of the discretionary authority involved in the approval process and would reduce the bias that exists against smaller, local firms.

7. Lack of Competition for Air and Sea Freight

While little can be done about the lack of competition for air and sea freight that results from the low volume of export activity, the same is not true of the monopoly conferred on Air Madagascar/Air France in the shipment of air freight. This legal monopoly on domestic and international operations should be eliminated and open competition should be encouraged, including the use of private air cargo planes as soon as the volume of activity makes this profitable. In addition, lifting the requirement that coastal trade be limited to vessels flying the Malagasy flag would also increase competition in this service.

8. Inadequate Transportation and Telecommunications

Although this report is not concerned primarily with infrastructure, it is evident that poor transportation and telecommunications not only increase costs but also have an important institutional consequence in that they limit a country's ability to respond to the exigencies of today's world markets, which require good timing and quality control. As a result, one cannot stress too much the importance of dealing with these problems as quickly as possible. Priorities identified in the case studies include vastly improved internal telecommunications in both countries. This may require such innovative approaches as expanded use of wireless systems, such as cellular telephones, that do not depend on heavy investment in central infrastructure. Other priorities for Madagascar include expanded and improved port capacity and improved secondary, and in some cases primary, roads. There is also the need for a freight terminal in Antananarivo.

9. Excessively Complicated or Restrictive Regulations Regarding Land and Labor

Few firms mentioned labor and land regulations as important problems inhibiting the expansion of nontraditional exports. One reason for this, in the case of labor, is either that the firms are exempt from these requirements because of their being approved under one of the special incentive programs or that they simply hire labor temporarily so as to avoid the requirements. In neither instance are the requirements being complied with, though their existence may make firms reluctant to hire new workers. It would be preferable, therefore, to liberalize substantially the hiring and firing of labor so as to enable firms to rid themselves of unproductive workers and to adapt flexibly to changing economic circumstances.

Although most firms in the surveys did not cite problems with land registration as being very important, there are enough instances in which they have been important that there is a need to take action. In Ghana, much could be accomplished by simply publicizing very clearly the various steps that must be taken to register land and by noting the severe complications that can occur if each of these steps is not taken in the order required. In Madagascar, the situation is more complicated because of the absence of up-to-date and clearly written legislation regarding land registration. The passing of this legislation should have high priority.

10. Lack of Qualified Labor and Middle-level Managers

Means should be sought for governments to support the private sector in its training of labor and middle-level managers for the nontraditional export sector. This support could take the form of tax credits to individual firms where the training would carry benefits that the firm is not able to capture fully. Alternatively, the public sector could join with professional associations in developing training programs at the industry level.

11. Problems in Contract Enforcement with Overseas Importers

Problems of contract enforcement are common in international trade and institutional means exist to overcome them. One of the most common is to engage the services of a reputable surveyor to assess damages. This is often done by the importer, with the surveyor's report made available to the exporter. Exporters should insist on such a procedure whenever damage claims are made.

VI. AREAS OF FUTURE RESEARCH

In order to improve the effectiveness of these studies and to sharpen the recommendations arising out of them, there are a number of research topics that need to be pursued. Most of these have been identified previously in this report and are brought together here in order to present a preliminary research program.

Areas of Comparative Advantage. Further work is needed to identify areas of comparative advantage for African countries related to nontraditional exports. Patterns of international trade are changing rapidly with the growth of high-value agricultural products, quality handmade goods, products with a particular cultural origin (Afrocentric products), products finding niche markets, and standardized products for which production at varying stages may take place in several different countries. Research needs to be undertaken to identify these products, to assess Africa's comparative advantage in producing and exporting them, and to see what institutional constraints inhibit the exploitation of this advantage. An important element of this research is to understand better the extent to which Africa needs to be highly competitive today or has time, because of ecological or cultural factors, to develop the institutions required to achieve that competitiveness.

Overseas versus Regional Markets. An important issue is the advantages and disadvantages associated with exporting to overseas versus regional markets. To what extent is the overseas demand for nontraditional exports from Africa more elastic than regional demand within Africa? Is there a better transfer of technology and managerial know-how if exports go overseas? Are overseas markets more difficult to break into than regional markets? Are contracts more difficult to enforce? Is it true that younger firms tend to export overseas whereas older firms have a greater tendency to export to neighboring countries? If so, what does this say about the best way to foster contacts between domestic exporters and foreign importers?

Controls on Exporters' Earnings of Foreign Exchange. There is a great need to study the types of controls that governments place on exporters' earnings of foreign exchange and the costs that these impose. In many cases in which there has been substantial liberalization of the exchange system, governments still exert pressures on exporters, through the banking system or by other means, to convert their earnings into local currency. Even if the exchange rate is unified, that is the bank rate and the parallel market rate are the same, the effect of this pressure is to increase artificially the demand for local currency, thus leading to its overvaluation. In other countries in which formal controls are still in place, the impact on the profitability of exports can be devastating (e.g., Madagascar prior to May 1994). Of special concern is the extent to which controls exist today within the CFA zone, where these countries are trying to maintain a fixed exchange rate at a new devalued level.

Duty-free Admission of Imported Inputs. High priority must be assigned to the establishment of mechanisms for the duty-free admission of imported inputs used in the production of exports. A study should be undertaken immediately of how these schemes have worked in East Asia and other developing countries, with a view to adapting them to African conditions. In addition, the efforts underway in countries such as Ghana and Madagascar to improve the procedures for duty-free admission or duty drawback should be carefully monitored to see how well and under what conditions they work. An assessment should also be made of how increased computerization of the customs service can create opportunities for innovations that were not possible when all processing and record-keeping was done manually.

Improved Access to Finance. A number of efforts are underway to increase the availability of finance to the export sector for both fixed investment and working capital. These efforts include innovations involving leasing, insurance, and credit guarantees. They need to be monitored and their results evaluated. Studies of the development of trade finance in other countries, such as those of East Asia, need to assessed with respect to their relevance for Africa at its current stage of development.

Special Incentive Programs. Some countries in Africa are beginning to experiment in their use of special incentive programs designed to encourage investment and exports. Attempts are being made to make these programs more promotional rather than regulatory, to simplify and speed up the approval process, and to use *ex post* rather than *ex ante* criteria in meeting requirements. In some instances, such as Madagascar, consideration is being given to eliminating the special programs altogether and to incorporating the incentives directly into tax codes and other laws that apply to all firms equally. These experiments need to be monitored closely to see how well they work and can be applied elsewhere.

Quality Control and Timeliness. Quality control and timeliness are likely to become increasingly important features of competitiveness in international trade. The ability to achieve these depends critically on good transportation and telecommunications, but where these are lacking, as they often are in Africa, what are the options and priorities for investment? For example, are there some products for which quality control and timeliness are less important than for others, and can African nations try to move ahead first in these? Is it possible to leapfrog over the need for massive investment by using more decentralized infrastructure such as cellular telephones? Which infrastructural investments should receive the highest priority? How have other developing countries dealt with this problem, or did they start to export before these requirements became so important?

Contract Enforcement. What are the standard procedures used throughout the world for enforcement of international contracts and why are these not being used more by African exporters? Is the problem one of lack of information or is it related to costs? What are the problems, if any, associated with the use of surveyors to assess damages? Would the use of factoring agents be a practical solution?

Legal and Judicial System. The legal and judicial systems in Ghana, Madagascar, and most other African countries, leave a great deal to be desired. They are slow, costly, and uncertain. Yet exporters do not indicate that this is a major problem. The hypothesis is put forward above that this lack of concern is because firms have found informal means of conducting their business and more formal mechanisms are not required for protection of property rights and enforcement of contracts. But the work of Douglass

North and others suggests that a strong legal and judicial system is critical to the expansion of commercial activity because it permits the emergence of complex impersonal forms of exchange. Thus, while the lack of such a system may not be much of a problem today, it is likely to become an increasingly important constraint in the future. This hypothesis needs to be tested and an assessment needs to be made as to when this constraint is likely to become binding.

Measures to Promote Exports. Given the strong bias that exists against nontraditional exports, it is important to investigate ways in which this bias might be offset by active measures to promote exports. A number of these measures have been undertaken in Asia, but it is often argued that Asian conditions are so different with respect to the quality of the civil service, the ability of governments to finance subsidies, and other areas that the lessons of Asia have little relevance for Africa. This assumption needs to be examined carefully, especially if comparisons are made with Southeast Asia rather than East Asia, which is relatively more advanced. Among the active measures that have been used in Asia to promote exports are credit subsidies and guarantees, income tax deductions, accelerated depreciation, special rates on public utilities, and marketing assistance.